

Internal Revenue Service

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Legend

X =

State 1 =

State 2 =

N =

Date =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 =

Dear :

This responds to a letter dated Date, submitted on behalf of X by its authorized representative, requesting rulings regarding X's treatment as an S corporation.

Spousal Consents

The information submitted states that X was formed in State 1 on Date 1, and made an election to be treated as an S corporation effective Date 2. N of the shareholders who consented to X's S corporation election were residents of State 2 and married at the time the election was made. The shares of X held by those shareholders appear to be held as community property. The spouses of these N shareholders failed to sign the Form 2553, Election by a Small Business Corporation on Date 2. Therefore, X's S corporation election was ineffective.

X represents that the failure to provide all of the consents for its S corporation election was inadvertent and unintended. The spouses have since consented to X's S corporation election and represented that they have filed their federal personal income tax returns since Date 2 consistently with X's S corporation status.

Composite Returns

The information submitted states in Year 1, Year 2, Year 3, Year 4, Year 5, and Year 6, X filed composite state income tax returns on behalf of some its shareholders. X also paid the composite tax due on those returns on behalf of its shareholders. X did not have any written or oral agreement with its shareholders to make these payments. X represents the composite tax payments should have been treated as constructive distributions, which caused the distributions X made to its shareholders be disproportionate in Years 1, 2, 3, 4, 5, and 6.

X represents it did not intend to create a second class of stock or to terminate X's S corporation election and that the circumstances resulting in the possible termination of the election were not motivated by tax avoidance or retroactive planning. X represents it will make remedial distributions to correct the effect of the potential disproportionate distributions X may have made.

Conversion Provision

On Date 3, X filed an amendment to its Articles of Incorporation ("Date 3 Amended Articles"). The Date 3 Amended articles included a provision allowing for both voting and nonvoting shares of X's capital stock. Article IV of the Date 3 Amended Articles provides that the common stock shall be identical in all respects, except for certain voting rights. Article IV.D.4 provides for a conversion of nonvoting shares into voting shares in the event of an initial public offering of X ("Conversion Provision"). The

Date 3 Amended Articles provided for an adjustment in the conversion price in the event of sales or issuances or deemed sales or issuances of Voting Stock below the then applicable "Conversion Price," a defined term within the Date 3 Amended Articles.

The Articles of Incorporation were once again amended and restated on Date 4. The amended articles were substantially similar to the previous articles.

There has been no initial public offering of X. Further, X represents that the Conversion Provision, whether or not it was triggered, did not cause X to make disproportionate distributions to any shareholder. On Date 5, X's Articles of Incorporation were amended and restated to remove the Conversion Provision.

X represents that X and each of its shareholders have filed consistently with the treatment of X as an S corporation since Date 2. X and its shareholders have also agreed to make any adjustments that the Commissioner may require, consistent with the treatment of X as an S corporation.

Law and Analysis

Section 1361(a)(1) of the Code provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for such year.

Section 1361(b)(1)(B) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual.

Section 1.1362-6(a)(2) of the Income Tax Regulations provides that a small business corporation makes an election under § 1362(a) to be an S corporation by filing a completed Form 2553. The election form must be filed with the service center designated in the instructions applicable to Form 2553. The election is not valid unless all shareholders of the corporation at the time of the election consent to the election in the manner provided in § 1.1362-6(b). However, once a valid election is made, new shareholders need not consent to that election.

Section 1.1362-6(b)(2) of the Income Tax Regulations provides that when stock of the corporation is owned by husband and wife as community property (or the income from the stock is community property), or is owned by tenants in common, joint tenants, or tenants by the entirety, each person having a community interest in the stock or income therefrom and each tenant in common, joint tenant and tenant by the entirety must consent to the election.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides that a corporation is generally treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.

Differences in voting rights among shares of stock of the corporation are disregarded for purposes of determining whether a corporation has more than one class of stock.

Section 1.1361-1(l)(2)(i) provides that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the “governing provisions”). A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement. Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Section 1362(d)(2) provides that (A) in general, an election under § 1362(a) shall be terminated whenever (at any time on or after the first day of the first taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation and (B) any termination under § 1362(d)(2) shall be effective on and after the date of cessation.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation (A) was not effective for the taxable year for which made (determined without regard to § 1362(b)(2)) by reason of a failure to meet the requirements of § 1361(b) or to obtain shareholder consents or (B) was terminated under § 1362(d)(2) or (3), (2) the Secretary determines that the circumstances resulting in the ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness or termination, steps were taken (A) so that the corporation is a small business corporation or (B) to acquire the shareholder consents, and (4) the corporation and each person who was a shareholder of the corporation at any time during the period specified pursuant to § 1362(f), agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in the ineffectiveness or termination, the corporation will be treated as an S corporation during the period specified by the Secretary.

Conclusion

Based solely on the facts submitted and the representations made, we conclude that X's S corporation election was not effective as of Date 2 under § 1362(a)(2), because N spouses, whose consent was required, failed to consent to X's S corporation election. We further conclude that, pursuant to the provisions of § 1362(f), X will be treated as being an S corporation from Date 2 and thereafter, provided that X is

otherwise eligible to be an S corporation and provided that the election was not otherwise terminated under § 1362(d).

Based solely on the facts submitted and the representations made, we conclude that because X's stock has identical distribution and liquidation rights under its governing provisions, the composite tax payments did not cause X to have more than one class of stock for purposes of § 1361(b)(1)(D). Under these circumstances, we conclude that X's S corporation election did not terminate because of the disproportionate distributions. However, disproportionate and corrective distributions must be given appropriate tax effect.

Finally, based solely on the facts submitted and the representations made, we conclude that X's S corporation election may have terminated because the Conversion Provision in X's Articles of Incorporation may have created more than one class of stock. However, we conclude that, if X's S election was terminated, such a termination was inadvertent within the meaning of § 1362(f) of the Code. Therefore, pursuant to the provisions of § 1362(f), X will be treated as an S corporation from Date 2 and thereafter, provided X is otherwise eligible to be an S corporation and provided that the election was not otherwise terminated under § 1362(d).

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provisions of the Code. In particular, we express no opinion regarding the validity of any § 338(h)(10) election. See Treas. Reg. § 1.338(h)(10)-1(c)(3).

In accordance with the Power of Attorney on file with this office, a copy of this letter ruling will be sent to the taxpayer's representatives.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Bradford Poston
Senior Counsel, Branch 2
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

cc: